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Securities Regulation -- Amendment of the Social and Political Exclusion for Shareholder Proxy Proposals

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Securities Regulation—Amendment of the Social and Political Exclusion for Shareholder Proxy Proposals

The Securities and Exchange Commission (SEC) recently adopted certain amendments to its rule governing shareholder proxy solicitations.[1] Probably the most important amendment is the revision in rule 14a-8(c)(2), which deals with the right of management of a corporation to exclude from its proxy statement a shareholder proposal dealing with a general social or political issue. This revision is the latest development in the growing management-shareholder controversy over the proper scope of shareholder initiative in forming corporate policy.

In order to increase shareholder participation in the governing of corporations, the Securities and Exchange Act of 1934 empowered the SEC to make rules governing the solicitation of proxies by any person in respect of any security registered under the Act.[2] Nevertheless, it was not until 1942 that the SEC implemented the statute with a rule requiring management to include in its annual proxy statement a shareholder proposal to be made at the annual shareholder meeting.[3] The rule carried the limitation that management could omit a shareholder proposal from the proxy statement if it concerned a matter that was not a "proper subject" for shareholder consideration under the law of the state of incorporation.[4]

In 1945, in upholding a corporation's decision to omit from its proxy statement a shareholder proposal calling for a revision of the tax and antitrust laws,[5] the SEC decreed that shareholder proposals dealing with matters of general political or social concern could be categorically omitted from management's proxy statement.[6] The release stated that the rule was intended to force inclusion only of proposals directly relating to the corporation's affairs.[7] This decision was generally interpreted

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[1]SEC Securities Exchange Act Release No. 9784, 2 CCH FED. SEC. L. REP. ¶ 24,012 (Sept. 22, 1972), *amending* 17 C.F.R. § 240.14a-8 (1971).

[2]Securities Exchange Act of 1934 § 14a, 15 U.S.C. § 78n(a) (1970).

[3]SEC Securities Exchange Act Release No. 3347, 7 Fed. Reg. 10656 (Dec. 18, 1942).

[4]*Id.*

[5]SEC Securities Exchange Act Release No. 3638, 11 Fed. Reg. 10995 (Jan. 3, 1945). The specific proposals omitted were for an end to "double taxation" of dividends, a revision of the antitrust laws and their enforcement, and a requirement that all federal laws providing for worker and farmer representation also provide for investor representation.

[6]Allen, *The Proxy System and the Promotion of Social Goals*, 26 BUS. LAWYER 481, 485 (1970).

[7]The release said that:

> [I]t is the purpose of Rule X-14a-7 [now 14a-8] . . . to place stockholders in a position to bring before their fellow shareholders matters of concern to them as stockholders in

as drawing a distinction between proposals over which the corporation had the power to act, which would be includible in management's proxy statement, and those matters of *general* interest to all citizens over which it had no power to take any action and which therefore belonged in another forum.[8]

In 1951 this distinction was judicially expanded[9] when a federal district court approved an SEC decision to allow Greyhound Corporation to omit a shareholder proposal "to consider the advisability of abolishing the segregated seating system in the South."[10] Seemingly the corporation had power to act on this proposal, at least to consider abolishing segregated seating on its buses, and therefore the proposal should not have been omittable as a general social matter under the interpretation generally ascribed to the 1945 release.[11] (A mandate that Greyhound actually abolish segregated seating on its buses would have been to no effect, however, since in several southern states at that time such action would have been illegal. As a result, all Greyhound could do was "consider the advisability" of integrating its buses.[12]) Perhaps the court's holding can be best explained by assuming that the determinative factor was the purpose of the shareholder in advancing the proposal rather than the relation of the proposal to the corporation's business.[13]

In 1952 the SEC explicitly codified the 1945 release by providing in rule 14a-8(c)(1) that management may omit a shareholder proposal "if it clearly appears that the proposal is submitted by the securityholder . . . primarily for the purpose of promoting general economic,

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such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders' action under the laws of the state under which it is organized. It was not the intent of [the rule] to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social, or economic nature. Other forums exist for the presentation of such views.

SEC Securities Exchange Act Release No. 3638, 11 Fed. Reg. 10995 (Jan. 3, 1945).

[8]Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 421, 440-41 (1971) [hereinafter cited as Schwartz].

[9]*Id.* at 442.

[10]Peck v. Greyhound Corp., 97 F. Supp. 679 (1951). The resolution dealt with by the court in *Peck* is the single litigated proposal dealing with a moderate social issue up until 1969. Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 STAN. L. REV. 481, 486 (1972) [hereinafter cited as Manne].

[11]SEC Securities Exchange Act Release No. 3638, 11 Fed. Reg. 10995 (Jan. 3, 1945).

[12]Schwartz 441.

[13]Note, *Corporate Political Affairs Programs*, 70 YALE L.J. 821, 846 (1961). Precisely how much weight should be given to the judicial sanction of the SEC's no-action letter in *Peck* is unclear because the court's opinion dealt only with administrative remedies and never addressed the merits.

political, racial, religious, social or similar causes."[14] Under this provision a decision as to whether or not a proposal was excludable invariably required an examination of the proponent's motives in making the proposal. This resulted in the exclusion of shareholder proposals, whatever their relevance to the business of the corporation, if the SEC determined that they were motivated primarily by concern for political or social issues.[15]

Concern with the motives of shareholder-proponents has been the most strongly criticized aspect of the political and social exclusion of rule 14a-8. In addition to permitting omission of proposals which are otherwise proper subjects for shareholder consideration, it has required that the primary purpose be deciphered from among all the varied purposes a shareholder may have in offering a proposal. Furthermore, the SEC had to undertake this task "without psychological expertise and often without more evidence than papers drafted by the shareholder's lawyer." Such a subjective test of purpose gave the SEC "wide discretion to make arbitrary rulings."[16]

The concern with motives has also resulted in the anomalous situation of some public-interest questions being excluded "although they dealt with subject matters that another shareholder might have been allowed to raise,"[17] often because an improper motive was inferred from an association of the shareholder with a certain political or social cause.[18] An additional problem with the rule was its failure to give the socially concerned shareholder a clearly defined guideline as to which proposals could be included in management's proxy statement. In addition to the inherent ambiguity of the rule and the lack of judicial caselaw on the subject, the SEC published no compendium of rulings and generally gave no reasons for its decision in any given case.[19] This lack of

[14]SEC Securities Exchange Act Release No. 4775, 17 Fed. Reg. 11433 (Dec. 11, 1952). The Director of the Division of Corporate Finance of the SEC said that the purpose of the revision was to codify the 1945 release. Schwartz 442.

[15]Heller, *Stockholder Proposals*, 4 VA. L. WEEKLY *DICTA* COMPILATION 72, 73-74 (1953) [hereinafter cited as Heller].

[16]Note, *Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals*, 80 YALE L.J. 845, 855-56 (1971).

[17]Schwartz 448.

[18]Heller 74. Examples of proposals excluded under 14a-8(c) (2) largely because of an association of the proponent with a social cause were proposals that a corporation cease investing in liquor stocks and that women employees be given the same pension rights as men. *Id.*

[19]Schwartz 443. 17 C.F.R. § 200.81(c) (1971) provides that the SEC need not make public any letters of comment or other communications relating to the adequacy of any proxy filed with the Commission. A reason given for this is that material in a shareholder's proposal may be

disclosure led to a paucity of information as to the specific standards used by the SEC in deciding which shareholder proposals violated the political and social exclusion.

The thrust of the arguments used to justify the exclusion was that it "operated to exclude frivolous and crackpot proposals as well as those motivated solely by considerations extraneous to the welfare of the particular company."[20] A stockholder who owned a nominal share of a corporation, which he had purchased only so that he would be able to use the corporation's proxy machinery, should not be permitted to put the company to the expense of providing him with a sounding board for his political and social beliefs.

In 1969 another rare judicial sanction was added to the rule when a court permitted the exclusion of a proposal for an oil company to encourage underwater oil exploration and the creation of a "stable international regime" to help foster this.[21] In 1970 a group called Campaign to Make General Motors Responsible, popularly known as Campaign GM, sought inclusion of nine proposals calculated to stimulate public debate on the role of corporations in the economy.[22] Under the prevailing interpretation of the political and social exclusion, all of the proposals should have been excluded because the admitted purpose of the proponents was to bring about social change.[23] Seven of the proposals that specifically dealt with social policy issues were in fact excluded.[24] One proposal—to increase the board of directors by three members—was ordered included as written, probably because it did not show any social motivation on its face and because enlarging the board of directors has traditionally been considered to be within the shareholder's sphere of initiative.[25] The other proposal ordered included called for the establishment of a shareholder Committee for Corporate Responsibility.[26] Perhaps the two proposals were included because if General Mo-

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"misleading" to the public. Telephone interview with Peter Romeo of the SEC, March 1, 1972. As part of the recent amendments, however, the SEC also changed this rule so as to treat material filed with it regarding shareholder proposals as matters of public record. SEC Securities Exchange Act Release No. 9785, 3 CCH FED. SEC. L. REP. ¶ 66,482 (Sept. 22, 1972).

[20]Heller 77.

[21]Brooks v. Standard Oil Co., 308 F. Supp. 810 (S.D.N.Y. 1969). As was the case in Peck v. Greyhound Corp., 97 F. Supp. 679 (1951), the court here also failed to specify the particular exclusion under which it upheld the decision to omit the shareholder proposal.

[22]For a thorough review of the Campaign GM experience see Schwartz 421.

[23]Comment, *A Judicial Challenge to the SEC's Shareholder Proposal Rule,* 28 WASH. & LEE L. REV. 147, 154 (1971).

[24]Manne 487.

[25]Comment, 28 WASH. & LEE L. REV., *supra* note 23, at 155.

[26]Schwartz 453. The proposal for the shareholder committee was ordered included subject to

tors had been allowed to exclude all nine proposals, a public controversy might have arisen over the continued anti-shareholder attitude generally displayed by the SEC in its proxy rulings. The Campaign GM ruling was a facesaving compromise in that it "allowed the two proposals on which the strongest argument for inclusion could be made, while rejecting those without supporting precedent."[27]

The next break in the rule's interpretation, "one that shatter[ed] past assumptions . . . about the scope of" the rule,[28] was the decision of the Court of Appeals for the District of Columbia in *Medical Committee for Human Rights v. SEC.*[29] A group which had acquired a few shares of stock in Dow Chemical Company requested that Dow include in its proxy statement a resolution that any napalm it produced "shall not be sold to any buyer unless that buyer gives reasonable assurance that the substance will not be used on or against human beings."[30] The court held that the political and social exclusion could be applied only to proposals unrelated to a corporation's activities.[31] The court interpreted "the word 'general' in [the rule] as ruling out attempts to secure a consensus of shareholder opinion on political issues whose resolution is not within the corporate power, and distinguished the Medical Committee's proposal as relating 'to a matter that is completely within the accepted sphere of corporate activity and control.' "[32] The court viewed the exclusion as covering only proposals for *general* social reform, and not covering proposals for the corporation to conform to a particular ideology rather than to increase profitability.[33]

In addition, the court said that rule 14a was not designed to allow management to treat "modern corporations with their vast resources as personal satrapies implementing personal or moral predilections" free from shareholder interference. Because Dow's management had publicly stated that it was producing napalm for political—and not profit-making—reasons, the court implied that the Medical Committee's proposal might have to be included regardless of the proponent's motive in offering it.[34]

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certain revisions made by the SEC. *Id.*

[27]Manne 488.

[28]Chisum, *Napalm, Proxy Proposals and the SEC,* 12 ARIZ. L. REV. 463, 463 (1971).

[29]432 F.2d 659 (D.C. Cir. 1970), *vacated as moot,* 404 U.S. 403 (1972).

[30]432 F.2d at 662.

[31]432 F.2d 659 (D.C. Cir. 1970); *see* Comment, *Proxy Rule 14a-8: Omission of Shareholder Proposals,* 84 HARV. L. REV. 700, 723 (1971).

[32]Comment, 28 WASH. & LEE L. REV., *supra* note 23, at 151.

[33]Chisum, *supra* note 28, at 472-73.

[34]432 F.2d at 681. The idea was that "management has no right to operate the corporation

Thus the *Medical Committee* court seemed to return to the pre-1951 interpretation of the political and social exclusion under which the personal "philosophy that may have motivated the resolution is irrelevant."[35] The SEC apparently acquiesced in this interpretation,[36] as it appealed only the administrative law question of whether an SEC no-action letter was judicially reviewable.[37] Since the *Medical Committee* decision, the SEC has ordered the inclusion of a shareholder proposal in a mutual fund's proxy statement requiring the fund to take into consideration before investing in any corporation: (1) the corporation's record in pollution control; (2) its record in complying with the civil rights laws; and (3) "whether the corporation has invested in South Africa, Rhodesia, or Angola, and if so, what action it has taken to" change those countries' oppressive political practices.[38] It would seem that under the interpretation of the rule prevailing between the *Greyhound* case in 1951 and the *Medical Committee* case this proposal would have been clearly omittable by management.

The new rule 14a-8(c)(2) (ii)[39] provides that management may omit a shareholder proposal if it "consists of a recommendation, request or mandate that action be taken with respect to any matter, including a general economic, political, racial, religious, social or similar cause, that is not significantly related to the business of the issuer or is not within the control of the issuer." The release announcing the amendments comments that the revision was designed to replace the subjective terms of the rule with objective standards in order to reduce uncertainty in applying it.[40]

Undoubtedly the new provision is an improvement over the old one. It does away with the need to examine the motives of shareholder-proponents of political and social proposals and thus dispenses with the most subjective element of the old rule. It also furnishes a clearer guideline as to which proposals violate the social and political exclusion. However, the rule does not seem to be of sufficient clarity to create true certainty in application.

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in a manner designed to advance its own social, political, or moral goals to the exclusion of the goals sought by the shareholders." Allen, *supra* note 6, at 492.

[35]Schwartz 461.

[36]Manne 489-90.

[37]*See* SEC v. Medical Committee for Human Rights, 404 U.S. 403 (1972).

[38]Letter from Division of Corporate Regulation, SEC, to Fidelity Trend Fund, Inc., in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,070 (May 19, 1972).

[39]SEC Securities Exchange Act Release No. 9784, 2 CCH FED. SEC. L. REP. ¶ 24,012 (Sept. 22, 1972).

[40]SEC Securities Exchange Act Release No. 9784 (Sept. 22, 1972).

The greatest difficulty in applying the new rule will probably stem from the interpretation of the phrase, "significantly related to the business of the issuer." This may be a financial[41] or quantitative[42] relation, in the sense that the activity to which the proposal is addressed must constitute a large and important portion of the corporation's business activity for the proposal to be allowed. If so, the amendment will likely serve as a retreat from the decision in the *Medical Committee* case because the production of napalm was such a small fraction of Dow's operations that a shareholder proposal dealing with it would not be "significantly related" to Dow's business. However, if this interpretation were adopted, it would render the "significantly related to" language of (c)(2) meaningless from redundancy, because rule (c)(5)'s[43] proscription of shareholder proposals relating to the "conduct of ordinary business operations" would presumably apply to proposals dealing with insignificant aspects of the corporation's business.[44]

Alternatively, the phrase "significantly related" may refer to a relationship based on the nature of the business conducted by the company. For example, "a question concerning off-shore oil drilling could be significantly related to the business of a corporation in the business of producing oil even if that corporation did not itself conduct any off-shore oil drilling."[45] If such an interpretation were adopted, the rule would not provide an objective, workable guideline for the inclusion of shareholder proposals. Legitimate shareholder-management disagreements over the relation of the business with the political or social issue involved would be inevitable as it would be very difficult to show convincingly that a company's operations do not have an impact on a given social or political cause. A proponent could usually establish the relevancy of his social or political proposal to the corporation in any case. Thus it would be difficult for management to effectively characterize

[41]Letter from Gerald V. Niesar, Chairman, Corporations Committee, Barristers Club of San Francisco, to Charles J. Sheppe, Chief, Branch of Regulations and Legislative Matters, Division of Corporate Finance, SEC, Feb. 2, 1972.

[42]Letter from Martin Riger, Professor of Law, Georgetown University Law Center, to Charles J. Sheppe, Chief, Branch of Regulations and Legislative Matters, Division of Corporate Finance, SEC, Feb. 3, 1972.

[43]Rule 14a-8(c)(5), 17 C.F.R. § 240.14a-8 (1971).

[44]Nevertheless, this seems to be the interpretation favored by Professor Schwartz, who believes that the proposal is "probably intended to confine shareholders to consideration only of questions of policy as contrasted with the minutiae of daily business as discussed in the *Medical Committee* case." Letter from Donald E. Schwartz and Roger Foster to Charles J. Sheppe, Chief, Branch of Regulations and Legislative Matters, Division of Corporate Finance, SEC, Feb. 1, 1972.

[45]Letter from Gerald V. Niesar, *supra* note 41.

most well drafted proposals as not "significantly related to the business" of the corporation.

The alternative ground for excluding shareholder proposals (if they are not "within the control of the issuer") also contains a serious constructional problem. The SEC was obviously aware of the difficulties of interpreting this language because the only change it made in the rule as initially suggested[46] was to note that a proposal is not within the issuer's control if it does not have the power to "effectuate it." Even with this clarification, a major constructional problem remains as to exactly what must be within the corporation's control: the specific proposal offered by the shareholder or the ultimate political or social situation at which it is directed. The shareholder proposal mentioned earlier[47] which dealt with a corporation's investments in certain repressive countries illustrates this problem. In that proposal a shareholder requested that management take into consideration the racial policies of certain countries before investing in them. The corporation had the power to "effectuate" such consideration before making its investments, but obviously there was very little the investment company could do to "effectuate" change in the racial policies of the countries. Whether or not the new rule will permit exclusion of such shareholder proposals in the future cannot be predicted until this constructional problem is resolved, but it would seem that the "control" language would generally exclude such proposals. Nevertheless, in the context in which the SEC adopted the changes in rule 14a, it is unlikely that the SEC has retreated from the position it adopted after the *Medical Committee* decision, and there-

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[46]SEC Securities Exchange Act Release No. 9432, 36 Fed. Reg. 25432 (Dec. 22, 1971).

[47]*See* text accompanying note 38 *supra.*

[48]During the period allowed by the SEC for comments concerning the rule's proposed revision, the theme was constantly heard from management forces that the proxy rules should not permit inclusion of *any* proposal of a social or political nature. The feeling generally expressed was that the attention of management should be solely directed at the earning power of the corporation, and therefore management should not be required to expend time and money to furnish a forum for those few shareholders whose interest is to publicize their personal] political and social beliefs without regard for the profitability of the issuer. It was frequently suggested that there be some minimum number of shares held by a shareholder-proponent or that he be required to hold his investment for a minimum period of time before being able to force inclusion of any proposal. Certainly there is merit to these suggestions in light of the great expense a corporation must incur in simply going through the process of clearing a decision to omit a proposal with the SEC and in light of the contemporary phenomenon that a few individuals may buy a single share in many companies and then send an identical lengthy list of proxy proposals to each. However, given the increasing centralization of economic power in fewer and fewer corporations, such corporations cannot avoid having a significant impact on the political and social life of the country and therefore any rule encouraging isolation of their managements from any shareholder views is probably ill advised.

fore the "control" language may not be interpreted as excluding proposals dealing with the racial policies of countries in which the issuer is investing.

Despite the ambiguities in the new rule, it can probably be said that it was intended to represent a liberalization of the political and social exclusion of shareholder proposals. Aside from the question of whether the SEC should have moved in this direction at all,[48] the changes seem to fall short of supplying a truly objective, workable guideline. It appears probable that, for the time being, the battle will shift from questions of whether a particular proposal stems from improper motives of the shareholder or whether such improper motives dominate his intentions to questions of whether the proposal is "significantly related to the business of the issuer" or whether it is "within the issuer's control."

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Securities Regulation—Rule 10b-5—An Alternative to Scalping Palefaces Who Speak with Forked Tongues

To implement section 10(b) of the Securities Exchange Act of 1934,[1] the Securities and Exchange Commission fashioned rule 10b-5,[2] which has become an expanding source of litigation for securities viola-

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[1]Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1970).

[2]The rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1971).